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A PROPER PERSPECTIVE ON THE TWIN DEFICITS[1]

by Charles Wolf, Jr.

While it's true that the deficit twins -- the budget deficit and the trade deficit -- are important, the degree of concern currently being expressed about them is exaggerated. Failure to reduce, let alone eliminate, the deficits may be imprudent. It would not be a disaster.

Moreover, focusing on the deficits diverts attention from the economy's more significant longer-run problem: namely, the aggregate savings rate. Were the deficit problems to be eased while the savings rate remained low, U.S. economic prospects would be bleak. On the other hand, if the savings rate were raised by 2 or 3 percent of the GNP, the longer-term economic outlook would be sanguine whether or not the deficits remained.

To help focus on what's primary and what's secondary, it is worth recalling a few fundamentals about the deficit twins, the relation between them, and their consanguine parentage.

The trade deficit or, to be more accurate, the current account deficit, is definitionally equal to the difference between savings and investment. In an accounting sense, the amount by which investment exceeds savings is exactly equal to the amount by which imports of goods and services exceeds exports.

In the past decade, the aggregate U.S. savings rate has declined by about 3 or 4 percent (from about 16 or 17 percent of the GNP to about 13 percent)[2], while aggregate investment has remained at about the 17

[1]Presented in testimony before the Budget Committee of the Senate of the United States, February 22, 1989, Washington, D.C.

[2]One of the standard, but seriously misleading, practices in the sometimes polemical writing on this matter is to calculate the U.S. savings rate as *net* savings expressed as a fraction of *gross* national product, thereby shrinking the rate by 9 or 10 percent. This practice is both bad accounting and bad economics: bad accounting because depreciation charges should not be left out of the numerator if they are included in the denominator; bad economics because a relatively large proportion of U.S. plant modernization, as well as the technological advancement embodied in new equipment, is accomplished through capital consumption allowances and depreciation charges, which are non-taxable.

percent figure. This 3 or 4 percent difference has been reflected in the current account deficit. To reduce or eliminate the current account deficit implies either a reduction in investment, or an increase in savings, or a combination of the two.

While the precise determinants of the savings rate, as well as its accurate measurement, are both imperfectly understood and controversial, the government budget is clearly one of the important influences on aggregate savings. This follows from the accounting identity that gross savings represent the difference between gross national product and the *sum* of private consumption spending and government spending on goods and services. Thus, at a given GNP level, gross savings are reduced by either higher consumption or higher government spending. Government purchases of goods and services reduce aggregate savings *whether the government spending is financed by taxes or by borrowing*. The variable that matters is the *magnitude* of government spending: how it is financed is of secondary importance in its effect on savings. To the extent that taxes reduce savings, and government borrowing reduces private consumption spending (the so-called "Ricardian effect"), the size of the federal budget deficit is of secondary importance, while the size of government spending is of primary importance in its effect on savings.

Of course, there are good reasons for wanting to see the federal budget deficit reduced: for example, to keep interest rates down, to damp inflationary expectations, to restore fiscal policy as a credible instrument for countering recessions, and, finally, to convey -- internationally as well as domestically -- the image of a responsible government that lives within its means. While acknowledging that point, it's worth adding a few heterodoxical words to clarify, as well as extenuate, the effects of the federal budget deficit.

First, from the standpoint of the effects of budget deficits on credit markets and the international accounts, what matters is the consolidated budgets of the states as well as the federal government, not the federal budget alone. Because the states have amassed a

business expenses. Those who are guilty of this practice include many people who should know better, and some who do.

substantial aggregate budget surplus in recent years, the consolidated deficit shrinks by 50 to 60 billion dollars. Thus, the consolidated budget deficit that results for the current year is \$100 billion, or about 2 percent of the U.S. GNP -- a figure not out of line with comparable figures in Japan, West Germany, or the United Kingdom.

Second, the federal budget deficit exercises a braking effect on the otherwise strong political pressures in a pluralistic democracy for government spending to rise. In general, there is a small negative, but statistically significant, relationship between the size of the federal deficit in one year and the increase in federal spending in the succeeding year, net of inflation and net of debt service.

Finally, as Robert Eisner has demonstrated, there's a substantial component of capital formation in federal government spending. Eisner has estimated this component at between \$100 billion and \$250 billion annually -- the higher figure depends on whether military procurement and military R&D are included. It is not inappropriate to finance genuine and productive public infrastructure by government borrowing, because the this infrastructure contributes to improved functioning of the economy and to widening the tax base, provided the capital expenditures have been wisely selected in the first place.

Turning to the other twin, there are encouraging signs that the trade deficit is already diminishing under the impact of two powerful market forces: the lowered exchange value of the dollar, and the discipline imposed on U.S. producers by having to compete for market share with foreign imports in the U.S., and with foreign products in world export markets. As a result, the trade deficit in 1988 is likely to be about \$137 billion -- more than \$30 below the \$170 billion deficit of 1987. The 1988 figure will probably decrease further in 1989 by another \$20 billion or \$30 billion.

As the U.S. trade deficit declines, the adjustment problem this will create for the rest of the world will probably be considerably greater than that for the U.S. economy. It is too easy for our friends in Western Europe and East Asia to forget that, for the U.S. trade deficit to diminish, the trade surpluses of other countries -- especially Japan, West Germany, and the Asian NICs -- will have to

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decline; or they and other countries will have to experience trade deficits; or some combination of the two will have to occur. One finds much more criticism these days from European and Asian governments concerning the need for the U.S. to "do something about its trade deficit", than recognition of what this implies for their own economies! [3] And these implications remain whether the U.S. trade deficit is reduced by actions that affect the U.S. budget deficit, the U.S. savings rate, or U.S. investment.

This prospect could be adversely affected by one development that has generally been overlooked. The attractiveness of U.S. assets, including real property, to foreign investors may propel a continued strong desire by foreigners to invest in the United States, in the process raising the dollar's value and impeding the downward adjustment of the U.S. trade deficit. It is worth bearing in mind that capital flows can *generate* a trade deficit, rather than being generated by it.

In sum, neither deficit warrants alarm. The federal budget and the trade accounts are less significant indicators of the economy's health than are the maintenance of sustained real economic growth, high employment, and low inflation.

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[3] For example, by the end of the 1990s, Japan should become a "mature" creditor nation--earning more from its prior foreign investments than it is paying out in new investments, implying that it will be importing more than it is exporting.

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